

State of California
BOARD OF EQUALIZATION

SALES AND USE TAX REGULATIONS

Regulation 1502. COMPUTERS, PROGRAMS, AND DATA PROCESSING.

Reference: Sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015, and 6016, Revenue and Taxation Code.

(a) IN GENERAL. "Automatic data processing services" are those rendered in performing all or part of a series of data processing operations through an interacting assembly of procedures, processes, methods, personnel, and computers.

Automatic data processing services may be provided by manufacturers of computers, data processing centers, systems designers, consultants, software companies, etc. In addition, there are banks and other businesses which own or lease computers and use them primarily for their own purposes but occasionally provide services to others. Business rendering automatic data processing services will be referred to herein as "data processing firms."

(b) DEFINITIONS OF TERMS.

Additional copies — See (d) (5) (F).

Application — The specific job performance by an automatic data processing installation is referred to as an application. For example, data processing for a payroll may be referred to as a payroll application.

Coding — The list, in computer code, of the successive computer instructions representing successive computer operations for solving a specific problem.

Computer — A computer is an electronic device (including word processing equipment and testing equipment) or combination of components, which is programmable and which includes a processor (central processing unit or microprocessor), internal memory, and input and output connections. An electronic device otherwise qualifying as a computer remains a computer even though it may be used for information processing, data acquisition, process control or for the control of manufacturing machinery or equipment. The term does not include tape-controlled automatic drilling, milling or tape-controlled manufacturing machinery or equipment.

Custom computer program and programming — A computer program prepared to the special order of the customer. A program prepared to the special order of the customer qualifies as a custom program even though it may incorporate preexisting routines, utilities or similar program components. It includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer.

Data Entry (Including Encoding) — Recording information in or on storage media by punching holes or inserting magnetic bits to represent letters, digits, and special characters.

Input — The information or data transferred, or to be transferred from storage media into the internal storage of the computer.

Keystroke Verifying — Use of a machine known as a punched card verifier or tape transcriber, which has a keyboard, to ensure that information punched in or transcribed on storage media during the keypunching operation has been entered properly. The machine signals when the punched hole and the depressed key disagree, or when the data on storage media differs from depressed keys.

Off-Line — Descriptive of a system and the devices in a system in which the operation of equipment is not under the control of a computer.

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On-Line	— Descriptive of a system and the devices in a system in which the operation of such equipment is under control of a computer.
Output	— The information transferred from the internal storage of the computer to storage media or tabulated listing.
Prewritten Program	— A program held or existing for general or repeated sale or lease. The term also includes a program developed for in-house use which is subsequently offered for sale or lease as a product.
Processing of Customer— Furnished Information	— See (d) (5).
Program	— The complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem; includes both systems and application programs and subdivisions such as assemblers, compilers, routines, generators, and utility programs.
Proof Listing	— A tabulated listing of input.
Source Documents	— A document supplied by a customer of a data processing firm from which basic data are extracted (e.g., sales invoice).
Storage media	— Includes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.

(c) BASIC APPLICATIONS OF TAX.

(1) The transfer of title, for a consideration, of tangible personal property, including property on which or into which information has been recorded or incorporated, is a sale subject to tax.

(2) Charges for producing, fabricating, processing, printing, imprinting or otherwise physically altering, modifying or treating consumer-furnished tangible personal property (cards, tapes, disks, etc.), including charges for recording or otherwise incorporating information on or into such tangible personal property, are generally subject to tax.

(3) A transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer, including property on which or into which information has been recorded or incorporated, is generally a sale subject to tax. However, if the contract is for the service of researching and developing original information for a customer, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(4) Charges for the transfer of computer-generated output are subject to tax where the true object of the contract is the output and not the services rendered in producing the output. Examples include artwork, graphics, and designs.

(5) Charges for processing customer-furnished information (sales data, payroll data, etc.) are generally not subject to tax. (For explanation and specific application of tax, see (d) below.)

(6) Leases of tangible personal property may be subject to tax under certain conditions. (See Regulation 1660 for application of tax to leases.)

(7) Charges made for the use of a computer, on a time-sharing basis, where access to the computer is by means of remote telecommunication are not subject to tax. (See (i).)

(8) Generally data processing firms are consumers of all tangible personal property, including cards and forms, which they use in providing exempt services unless a separate charge is made to customers for the materials, in which case tax applies to the charge made for the materials.

(d) MANIPULATION OF CUSTOMER-FURNISHED INFORMATION AS SALE OR SERVICE.

(1) **GENERAL.** Generally tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation. However, if the contract is for the service of developing original information from customer-furnished data, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(2) **DATA ENTRY AND VERIFICATION.** This section covers situations where a data processing firm's agreement provides only for data entry, data verification, and proof listing of data, or any combination of these operations. It does not include contracts under which these services are performed as steps in processing of customer-furnished information as discussed under (d) (5).

Agreements providing solely for data entry and verification, or data entry, providing a proof list and/or verifying of data are regarded as contracts for the fabrication of storage media and sales of proof lists. Charges therefor are taxable, whether the storage media are furnished by the customer or by the data processing firm.

Tax also applies to charges for the imprinting of characters on a document to be used as the input medium in an optical character recognition system. The tax application is the same regardless of which type of storage media is used in the operation.

(3) **ADDRESSING (INCLUDING LABELS) FOR MAILING.** Where the data processing firm addresses, through the use of its computer or otherwise, material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for addressing. Similarly, where the data processing firm prepares, through the use of its computer or otherwise, labels to be affixed to material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for producing the labels, regardless of whether the data processing firm itself affixes the labels to the material to be mailed. (Sale of mailing list by proprietor of such list, as a sale of tangible personal property or as an exempt addressing, see Regulation 1504 "Mailing Services")

(4) **MICROFILIMING AND PHOTORECORDING.** Tax applies to charges for microfilming or photorecording except, as provided in paragraph (d) (5), where the microfilming or photorecording is done under a contract for the processing of customer-furnished information. Tax applies to a contract where data on magnetic tape are converted into combinations of alphanumeric printing, curve plotting and/or line drawings, and put microfilm or photorecording paper.

(5) PROCESSING OF CUSTOMER-FURNISHED INFORMATION.

(A) "Processing of customer-furnished information" means the developing of original information from data furnished by the customer. Examples of automatic data processing processes which result in original information are summarizing, computing, extracting, sorting, and sequencing. Such processes also include the updating of a continuous file of information maintained by the customer with the data processing firm.

(B) "Processing of customer-furnished information" does not include: (1) an agreement providing solely for the reformatting of data or for the preparation of a proof listing or the performance of an edit routine or other pre-processing, (2) the using of a computer as a mere printing instrument, as in the preparation of personalized computer-printed letters, (3) the mere converting of data from one medium to another, (4) an agreement under which a person undertakes to prepare artwork, drawings, illustrations or other graphic material whether the graphic material is transferred on storage media or otherwise. However, graphic material furnished incidentally to the performance of a service is not subject to tax. For example, graphics furnished in connection with the performance of architectural, engineering, accounting or similar professional services are not subject to tax.

(C) Contracts for the processing of customer-furnished information usually provide that the data processing firm will receive the customer's source documents, record data on storage media, make necessary corrections, process the information, and then record and transfer the output to the customer.

Where a data processing firm enters into a contract for the processing of customer-furnished information, the transfer of the original information to the customer is considered to be the rendition of a service. Except as described in (c) (8) above and (d) (5) (E) below, tax does not apply to the charges made under contracts providing for the transfer of the original information whether the original information is transferred on storage media,

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microfilm, microfiche, photorecording paper, input media for an optical character recognition system, punched cards, preprinted forms, or tabulated listing. The breakdown of the total charge into separate charges for each operation involved in processing the customer-furnished information will not change the application of tax.

(D) The furnishing of computer programs and data by the customer for processing under direction and control of the data processing firm will not alter the application of tax, notwithstanding that charges are based on computer time.

(E) Taxable Items. Where a data processing firm has entered into a contract which is regarded as a service contract under paragraph (d) (5) (C) above the data processing firm, pursuant to the contract, transfers to its customer tangible property other than property containing the original information, such as: duplicate copies of storage media; inventory control cards for use by the customer; membership cards for distribution by the customer; labels (other than address labels); microfiche duplicates; or similar items for use, tax applies to the charges made for such items. If no separate charge is made, tax applies to that portion of the charge made by the data processing firm which the cost of the additional computer time (if any), cost of materials, and labor cost to produce the items bear to the total job cost.

(F) Additional Copies. When additional copies of records, reports, tabulation, etc., are provided, tax applies to the charges made for the additional copies. "Additional copies" are all copies (other than carbon copies), whether the copies are prepared by rerunning the same program, by using multiple simultaneous printers, by looping a program such that the program is run continuously, by using different programs to produce the same output product, or by other means. Where additional copies are prepared, the tax will be measured by the charge made by the data processing firm to the customer. If no separate charge is made for the additional copies, tax applies to that portion of the gross receipts which the cost of the additional computer time (if any), the cost of materials and labor cost to produce the additional copies bear to the total job cost. Charges for copies produced by means of photocopying, multi-lithing, or by other means are subject to tax.

(e) TRAINING SERVICES AND MATERIALS. Data processing firms provide a number of training services, such as data entry and verification, programming and specialized training in systems design.

(1) Charges for training services are nontaxable, except as provided in (g) below where the training services are provided as part of the sale of tangible personal property. The data processing firm is the consumer of tangible personal property which is used in training others, or provided to trainees without a separate charge as a part of the training services.

(2) Tax applies to charges for training materials, including books, furnished to trainees for a charge separate from the charge for training services.

(3) Where a person sells tangible personal property, such as computers or programs, and provides training materials to the customer without making an additional charge for the training materials, this is a sale of the training materials. The selling price of the training materials is considered to be included in the sales price of the tangible personal property.

(f) COMPUTER PROGRAMS.

(1) **PREWRITTEN (CANNED) PROGRAMS.** Prewritten programs may be transferred to the customer in the form of storage media or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.

(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.

(B) Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of

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tax. Tax does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.

(C) Maintenance contracts sold in connection with the sale or lease of prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which prewritten program improvements or error corrections have been recorded. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

If the purchase of the maintenance contract is not optional with the purchaser, then the charges for the maintenance contract are taxable, including charges for consultation services, as part of the sale or lease of the prewritten program.

If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media. If, however, the purchaser may, at its option, contract for the consultation services for a separately stated price, in addition to the charges made for the storage media, then the charges for the consultation services are nontaxable.

(D) The sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller's place of business, to or through the purchaser's computer and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction. If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.

(E) The transfer of a prewritten program on storage media is not a sale for resale when the storage media, or an exact copy, will be used to produce additional copies of the program.

Charges for testing a prewritten program on the purchaser's computer to insure that such a program operates as required are installation charges and are nontaxable.

(2) CUSTOM PROGRAMS.

(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.

(B) However, charges for custom modifications to prewritten programs are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as services part of the sale of the prewritten program.

When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program, if the price of the prewritten program was 50% or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program, if the charge made to the customer for custom programming services, as evidenced in the records of the seller, was more than 50% of the contract price to the customer.

(C) Any written documentation or manuals designed to facilitate the use of a custom computer program by the customer are nontaxable, whether or not a separate charge is made for the documentation or manuals. The vendor of the custom computer program is the consumer of the written documentation or manuals, or of any tangible personal property used by the vendor in producing the written documentation or manuals.

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(D) A custom computer program includes a program prepared to the special order of a customer who will use the program to produce and sell or lease copies of the program. The copies, however, are taxable as prewritten computer programs. The later sale or lease of such copies does not affect the nontaxability of the original custom computer program.

(E) A computer program prepared to the special order of a customer to operate for the first time in connection with a particular basic operating system is a custom computer program even though a different version currently operates in connection with an incompatible basic operating system.

(g) SERVICE CHARGES. The following activities are service activities. Charges for the performance of such services are nontaxable unless the services are performed as a part of the sale of tangible personal property.

(1) Designing and implementing computer systems. (e.g., determining equipment and personnel required and how they will be utilized.)

(2) Designing storage and data retrieval systems. (e.g., determining what data communications and high-speed input-output terminals are required.)

(3) Consulting services. (e.g., study of all or part of a data processing system.)

(4) Feasibility studies. (e.g., studies to determine what benefits would be derived if procedures were automated.)

(5) Evaluation of bids. (e.g., studies to determine which manufacturer's proposal for computer equipment would be most beneficial.)

(6) Providing technical help, analysts and programmers, usually on an hourly basis.

(7) Training Services

(8) Maintenance of equipment. (See Regulation 1546 for application of tax to maintenance contracts.)

(9) Consultation as to use of equipment.

(h) PICK-UP AND DELIVERY CHARGES. If the data processing firm's billing is for nontaxable processing of customer-furnished information, the tax will not apply to pick-up and delivery charges. If pick-up and delivery charges are made in conjunction with the sale of tangible personal property or the processing of customer-furnished tangible personal property, the tax will apply to the pick-up charges. Tax will apply to the delivery charges to the extent specified in Regulation 1628 "Transportation Charges."

(i) RENTAL OF COMPUTERS. A lease includes a contract by which a person secures for a consideration the use of a computer which is not on his premises, if the person or his employees, while on the premises where the computer is located operate the computer, or direct and control its operation. A lease does not include a contract whereby a person secures access, by means of remote telecommunication, to a computer which is not on his premises, if the person or his employees operate the computer or direct and control its operation by means of remote telecommunication. (See Regulation 1660 for application of tax to leases.)

History: Adopted February 17, 1972, effective March 25, 1972.

Amended November 18, 1987, effective March 4, 1988. In subdivision (b), amended the regulation to conform several definitions with industry standards. In subdivision (c), amended the regulation to make clear and specific the basic application of tax. In subdivision (f), amended the regulation to make clear and specific the application of tax to prewritten computer programs.

Regulations are issued by the State Board of Equalization to implement, interpret or make specific provisions of the California Sales and Use Tax Law and to aid in the administration and enforcement of that law. If you are in doubt about how the Sales and Use Tax Law applies to your specific activity or transaction, you should write the nearest State Board of Equalization office. Requests for advice regarding a specific activity or transaction should be in writing and should fully describe the facts and circumstances of the activity or transaction.